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FRANCHISE ASSOCIATION OF NEW ZEALAND

THE PITFALLS OF BACKYARD TAX POLICY

THE PITFALLS OF BACK

Personal tax rates are likely to be a significant election issue. National proposes to introduce a three-step tax scale that would increase the level of income at which the top rate is applied and generally lower the rate of tax paid on middle incomes. In contrast, Labour proposes to introduce a new top rate of tax of 39 percent on incomes above $60,000.

The broad objective of tax and other policies should be to increase the overall welfare of the community to the maximum extent possible. Community welfare can take the form of higher output and incomes – and hence better material standards of living – increased opportunities for leisure, and/or other non-material benefits. Policies that are good for one person are usually beneficial from a community perspective, but there are some circumstances where the interests of an individual and those of the community as a whole conflict. In such cases it is the latter interests that are of prime importance. While questions of fairness and equity also arise, issues related to income distribution should, in my view, largely be addressed through welfare policies.

How do the tax proposals of National and Labour measure up against this standard?

The level of the tax burden is a key factor in judging the effect of tax policies on community welfare. Government spending is the best measure of the tax burden. Spending must generally be funded from current tax revenue or borrowing. As borrowing must eventually be repaid from taxes, it is ~~usually viewed as~~effectively deferred tax.

The government has a vital role to play in advancing community welfare, but it is a limited one. In 1651 Thomas Hobbes described life without government as "nasty, brutish and short". To avoid that outcome the government should be responsible for maintaining personal and national security, protecting property rights and setting the 'rules of the game' for wealth-creating endeavours. It should also facilitate the supply of goods and services that cannot be produced by the private sector and provide a safety net for people in need who cannot be helped in other ways, for instance by families and charities.

Some people may think that government spending should be increased until the point where the last dollar spent produces a dollar of benefits. However, this would lead to too much spending. The economic cost of raising the last dollar of revenue is greater than a dollar because taxes distort the behaviour of individuals and firms. This cost includes lower output, incomes and employment, and distortions to a host of other choices that people make every day. Some New Zealanders may decide to live in another country if they are taxed too heavily.

There is considerable research which concludes that the total economic costs of raising revenue are very large, probably close to 30 cents for the marginal dollar of taxation in New Zealand. For this reason we should use tax revenue sparingly and 'economise' on the amount of activity that we expect of the state. Such research has encouraged many countries, including New Zealand, to reduce their rates of income tax over the past couple of decades. Tax reductions have focused on lowering high rates of tax in particular.

New Zealand's tax burden is not declining. Government spending under National will increase by about $6 billion during the nine years to the end of the present parliament. Central government operational spending currently amounts to about 35 percent of gross domestic product (GDP). This ratio has not declined since 1994/95 despite the government's long-run objective under the Fiscal Responsibility Act of reducing it to 30 percent of GDP. The ratio is forecast in the recent budget to decline only slightly by 2001/02.

National's proposed tax reductions will cost $400 million a year. They were termed a 'down payment' on further reductions by National. However, such commitments are not credible unless the government spending ratio is also projected to fall. John Major's party in Britain similarly lacked credibility in claiming to be "instinctively the party of lower taxes" when it was in fact increasing spending and taxation. A serious programme of tax reductions requires a much more disciplined approach to spending than has been the case since Ruth Richardson lost the finance portfolio in 1993. Moreover, National has said that for every dollar of tax reductions, spending will be increased by a dollar. Thus it is promising to increase spending when a reduction in the tax burden is required to support credible tax cuts.

Labour, on the other hand, is clear about its intention to increase spending

of the additional revenue, reported to be up to $340 million, that might be raised by introducing a new top tax rate of 39 percent. It proposes, among other things, to

industry development, to extend ACC to sickness and to pre fund New Zealand superannuation.

proper role. It is implausible that the current level of spending generates benefits commensurate with its costs. A sizeable reduction in spending and taxes would be

Tax reductions should be designed to generate the largest possible gain in community is the level of tax payable on the next dollar of income (marginal income) that affects key

reasons, public policy should focus on reducing high rates of tax that apply to marginal income. The top rate of personal tax is the main case in point.

The top income tax rates particularly affect the tax burdens on capital income, which are particularly costly to the community. Investment that would be profitable from a ity perspective is discouraged, thereby harming growth and job creation. A tax on capital income increases the pre tax rate of return required to attract foreign investors to New Zealand. The rate of company tax is a key rate that applies to

investment and economic growth.

Income earned through companies, superannuation schemes, life insurance funds and

greater the extent to which effective marginal rates of tax move away from a flat rate, the more difficult it is to tax such income at the appropriate rate.

The present tax structure was predicated on the adoption of a relatively flat tax scale. The tax rates that applied before July 1996 were broadly consistent with that assumption. The majority of taxpayers were subject to the middle marginal tax rate of 28 percent or the top rate of 33 percent. Some people receiving welfare assistance or with student loans faced higher rates of tax. The top rate was reflected in the rates of tax applicable to company income, fringe benefits and superannuation schemes. People on the top rate were taxed appropriately while the penalty imposed on taxpayers who obtained fringe benefits or saved through superannuation schemes and were taxed on the middle marginal rate was relatively small.

The tax changes introduced in 1996 and 1998 resulted in a more uneven tax structure. They widened the gap between the top tax rate and the middle effective marginal income tax rate from 5 percentage points (33 percent and 28 percent respectively) to 12 percentage points (33 percent and 21 percent). In addition, the income level at which the top rate first applies was raised from $30,875 to $38,000. The incentive to split income among family members was greatly increased. The changes were made to distribute some of the benefits of the country's economic reforms to low- and middle-income earners. This was a reasonable goal, but the fact that higher tax rates were not cut at the same time led to much more serious distortions in the tax scale. People on lower and middle incomes saving through superannuation schemes and life insurance funds now face excessive levels of tax. As the TOLIS (Taxation of Life Insurance and Superannuation) exercise demonstrated, it is impossible to find a satisfactory solution to this problem short of lowering the top tax rate.

The introduction of the three-step tax scale proposed by National would make the tax scale even less uniform and would greatly accentuate the problem caused by the 1996 and 1998 changes. At present the first $9,500 of 'labour' income is taxed at an effective rate of 15 percent. This takes account of the statutory rate (19.5 percent) and the low-income rebate (LIR). The rebate applies to labour income, such as wages and salaries, New Zealand superannuation and benefits, but not investment income. The LIR is phased out as income increases beyond $9,500 such that the average rate of tax on an income of $38,000 is 19.5 percent.

National proposes to abolish the LIR and introduce a new statutory rate of tax of 15 percent on income up to $9,500. The effective rate of tax on labour income up to

$9,500 would remain unchanged. However, the tax rate on any investment income included in the first $9,500 of income would drop from 19.5 percent to 15 percent. The
o replace the middle effective rate of 21 percent with a statutory rate of 20 percent. The third element is to lift the threshold at which

National's proposals are a backyard approach to tax policy. In terms of the objective

taxpayer's buck' because much of the $400 million will be spent in reducing tax on intramarginal income, that is, tax that does not affect peo
or invest. The focus is on income redistribution, not wealth creation. The half a million taxpayers who earn more than $38,000, for instance, would gain a windfall of

threshold would provide a further windfall of $260 a year for people who earn more than $40,000. However, the tax rate applied to any extra income will continue to be

The relationship between personal rates of tax
fringe benefits, superannuation contributions paid by employers and income earned by superannuation schemes and life insurance funds would come under additional

forms of income would be 20 percent, or some 13 percentage points below the top rate compared with 5 percentage points up to 1996. For a few taxpayers the appropriate
a rate 18 points higher.
These are very wide gaps.

One consequence of these moves would be that the argument that fringe benefits, superannuation contributions, superannuation schemes and life funds should be taxed

rate taxpayers would exploit the opportunity and we would be back to the so-
tax effective remuneration packages that were common only a few years ago.

resident withholding tax rate of 15 percent for people such as school children who earn small amounts of interest or need to be lifted to 20 percent. This has led Grey Power to correctly observe that a superannuitant with $5,000 of investment income would pay more in withholding tax than at present.

The proposed scale would increase the scope for tax avoidance. The present rate of 19.5 percent on modest amounts of investment income does not create a strong incentive for high-income earners to shuffle their investment income among family members. A bottom tax rate of 15 percent would encourage this simple form of tax avoidance. The lifting of the income level at which the top rate applies would also foster income splitting. Before July 1996 the maximum annual saving per recipient from transferring income from a top rate taxpayer to a non-earner (say, a child) was about $2,780. Under the proposed scale it would be $5,675.

Another consequence is that the chances of flattening the tax scale would be reduced. We would hear political arguments that subsequent moves to cut the top tax rate would disproportionately benefit higher income taxpayers.

The earlier tax scale was generally well designed. The LIR provision reflects a compromise between the merits of taxing intramarginal income of middle and high income earners at a level that reduces the need for excessive rates of tax on marginal income, and a desire to impose a lighter tax burden on people with a low income. Concessionary rates of tax are not justified for all people on low incomes. Tertiary students, for example, are assisted in other ways while school children, young adults and spouses who work part time are often from high-income families.

In Australia the first A$5,400 of income is generally free from tax. While this reduces the tax burden on people who depend on low incomes, it confers the same benefit on millionaires and requires a higher tax rate on marginal income. It is a very costly way of helping people on low incomes. New Zealand began extricating itself from a similar trap in the 1970s. The abolition of the LIR and the lowering of the bottom statutory rate would be a mistaken step backwards.

National has advanced two main arguments for its tax scale. The first relates to simplicity and the second is that people do not know their effective marginal tax rates but would do so under the new scale. Both are questionable propositions. Simplicity is not an overriding goal. There could be nothing simpler than a world free from tax

necessary to avoid the anarchy that Hobbes described.

earned can find out without too much trouble. In a recent *Assignment* programme

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if they took up jobs that were offered. They had to ta

phase out of the unemployment benefit and the accommodation allowance. This is a

before it was announced or recommended by the Treasury or the Inland Revenue

Treasurer, Bill English, correctly made earlier this year of Labour's proposal.

Labour

some of the highest tax rates it would increase the economic or deadweight costs of

Being motivated by a desire to increase government spending, it would increase New

Logically it should also be applied to superannuation contribu

and the income of superannuation schemes and life insurance funds. But Labour

it has sought to fudge its position.

While Labour likes to remind us that Australia has a top personal tax rate of 47

Australia is less than in New Zealand according to the OECD, total spending by

around 33 percent of GDP compared with 41.5

rates in the next few years. New Zealand's income tax base is broader than higher than the less comprehensive GST of 10 percent which is to be introduced in Australia. Under Labour's proposals, the combination of a 39 percent tax rate and a 12.5 percent GST would mean that higher income taxpayers would be handing over nearly 50 percent of their income to the government.

There is also considerable scope to avoid Australia's high rates of personal tax. Superannuation savings, for example, are generally taxed at a low rate of 15 percent up to a high level of income – close to NZ$90,000. The Australian system facilitates many tax rorts, as every Australian knows.

If New Zealand were really serious about retaining or attracting the skills of outstanding innovators, entrepreneurs, artists and sports people, it ought to be setting a goal of applying a flat income tax of no more than, say, 20 percent. By going in the opposite direction, Labour will be sending a strong signal to productive people with international skills to migrate to countries with higher average incomes and/or lower overall tax burdens. To avoid losing people, firms will have to increase the gross salaries of many managerial and professional staff. This will add to the cost of doing business in New Zealand. The country loses all round.

There is actually a good case for looking at the idea of making New Zealand more attractive to high-skilled and entrepreneurial people by capping the maximum level of tax that any person would be required to pay at, say, half a million dollars a year. This approach would have several advantages. First, as the rate of income tax on income above the threshold would be zero, the behaviour of affected taxpayers at the margin would not be distorted by income tax. For such taxpayers the income tax would be close to the textbook example of an ideal lump sum tax. Secondly, many people on very high incomes would choose to pay the maximum tax rather than engage lawyers and accountants to manage their tax affairs and devise avoidance schemes. There would thus be a large reduction in activities which waste resources from a community perspective. Thirdly, government revenue would probably increase. I suspect that only a handful of individual taxpayers pay half a million dollars or more in tax each year. At present we are losing such people from the New Zealand tax base.

A taxpayer subject to such a cap would pay fully for his or her share of public

such as welfare support that benefits other people. Moreover, such taxpayers make a

trying to attract people with similar skills in other ways such as through favourable
olish to have a tax regime that sends the opposite

easily overstated. First, while compassion for those in hardship justifies a tax funded

to provide support and to fund it are separate matters. When all is said and done,

annual income
work part time to have more time for leisure activities, are they less well off than

progressive taxes tend to transfer income among different stages of a taxpayer's life
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People on high incomes will always gain the most from any tax cut because they pay a
of tax. It is taxpayers' money which is being returned, not

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think about their total federal, state and local taxes, including income, sales, payroll

would be fair for a family making US$200,000 a year almost NZ$375,000 to pay
was 25 percent well below

the result was consistent for males, females, whites and blacks, and high and low income earners.

While the 1984 1990 Labour government tax reforms were designed to improve

coming election seem to reflect short term political opportunism. They are motivated
ather than by an informed

analysis of what is good for the country. Neither National nor Labour is demonstrating leadership. Their tax proposals illustrate the erosion in the quality of public policy that has occurred over the past few years. It is contributing to lacklustre economic performance, and it is little wonder that more people think the country is on the wrong track than those who think it is heading in the right direction. The community deserves better.